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Governor
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Edward J. Stanek, Ph.D
President and CEO

TO: Members of the House and Senate Government Oversight Committees

**FROM: Tim Clausen, Sioux City
Iowa Lottery Board Chairperson**

DATE: Aug. 17, 2006

RE: Lottery Performance-Based Compensation Program

Today, the Iowa Lottery Board authorized payments to Lottery employees under the Lottery performance-based compensation program for fiscal year 2006, which was approved by the Board in 2004. The performance-based compensation payments apply to all Lottery employees except CEO Dr. Ed Stanek.

The Lottery has reported several times to the Legislature about the performance-based compensation program for lottery employees, which has existed since 1986. The most recent report was given to the House and Senate Government Oversight Committees in February 2004, the year in which the Board approved the current program. I have asked that the Lottery mail the 2004 report to your home address this week so you can re-familiarize yourself with it, but in the meantime, I have asked that this update be provided to you via e-mail.

History of the Program

The Iowa Lottery has had a performance-based compensation program for employees since 1986. Authorization for an incentive program was provided in the 1985 legislation that created the Iowa Lottery. When the Iowa Lottery transitioned to the Iowa Lottery Authority in 2003, similar language regarding incentives was included in Iowa Code Chapter 99G, which governs the Authority.

The performance-based compensation program for Lottery employees has varied through the years, at times being based on sales and/or profits. The amount of incentives paid to Lottery employees also has varied, based on the make-up of the program in a particular year and the number of employees who were eligible and achieved performance-based goals.

The current performance-based compensation program for Lottery employees was approved by the Iowa Lottery Board at its meeting on Oct. 25, 2004. The Board approved an incentive period from January-June 2005 and another incentive period that consisted of fiscal year 2006 (July 1, 2005, to June 30, 2006). The different periods of time were involved to sync the performance-based compensation program with the governor's annual review of the Lottery and its CEO. The governor's review for a time was based on the calendar year, but has switched to the fiscal year.

Following the Lottery Board's approval of the plan, the Lottery employee incentive program was formally accepted by the American Federation of State, County and Municipal Employees (AFSCME) in June 2005.

Under the current program, a performance-based compensation payment equal to 3 percent of Lottery staff's annual pay was to be made if the total Lottery transfers to the state totaled \$54 million for FY 2006. A payment of an additional 4 percent of the staff's annual salary was to be made if total FY '06 transfers exceeded \$57.5 million, and a prorated payment was to be made for transfers that totaled somewhere in between.

Minutes from Lottery Board Approval

The minutes from the Lottery Board's meeting on Oct. 25, 2004, reflect the following discussion:

Incentive Program

[Vice President of Sales Larry] Loss presented a proposed employee incentive program, noting that it was nearly identical to the program in place for the past two years. However, in order to have the program coincide with the Lottery's fiscal year for planning and budgeting purposes, an 18-month program was proposed, consisting of a six-month component and a 12-month component.

For the six-month period (Jan. 1 to June 30, 2005), employees would receive an incentive payment of 1.5% of annual base pay if total Lottery transfers to the state met or exceeded \$27 million, and an additional 2% if transfers were \$28.78 million or greater. For the 12-month component (July 1, 2005, to June 30, 2006), a 3% incentive would be paid if transfers to the state met or exceeded \$54 million, and an additional 4% if total transfers met or exceeded \$57.5 million.

Stanek noted that in the course of the past year, there had been some legislative initiatives to prohibit anything other than base pay for state employees, and the Governor had issued a directive in March of 2004 placing a moratorium on a number of special pay actions. Some exceptions to the moratorium included payments targeted to enhance performance and cut costs to the state general fund. The Lottery, instead, would be adding revenue to the general fund. Stanek indicated any Board approval of the incentive program would be subject to no finding by a person of appropriate authority that the program was inconsistent with the Governor's edict.

Clausen asked if the incentive would only apply to those employees employed as of the date the incentive ended.

Stanek replied that as proposed it would apply to anyone who had worked during that period, but only for the prorated number of hours they had worked.

Clausen observed that was a change from the terms of the last incentive program, and said he thought the goal of an incentive program was to promote good and hard work and also to promote employee retention. He said he did not believe employees not employed on the final day the incentive program should receive incentive pay.

Stanek said the change was made in an effort to be more fair. The goal was to encourage everyone to work as hard as they could for as long as they worked at the Lottery. To do otherwise would establish no motivation for employees leaving before the end of the incentive period, for whatever reason.

The Board discussed whether exceptions could be made for retirements, or perhaps on a case-by-case basis.

Clausen reiterated that he did not approve of rewarding someone who left for a better offer, leaving others to take up the slack.

Stanek observed that other employees had to take up the slack for an employee taking sick leave or vacation, and the employee would not be penalized for that.

Clausen moved to continue the lottery incentive program with two incentive periods that include a six-month component and a twelve-month component with the incentive as proposed but to include that it applies to only those employees who are employed on the last day of the incentive period. The motion failed for lack of a second.

McCoy made same motion, with the exception of employees who were retiring. Hearing no second, he withdrew the motion.

Stanek said that the staff had just reported to him that recent changes to the law had included the provision that once an employee had retired, payments could only be made to them if they were put back on the payroll, which was not permitted if they were collecting IPERS benefits. The same provision would apply also to anyone who left state employment for any reason.

Clausen restated his earlier motion. The motion was seconded by McCoy and carried unanimously.

January-June 2005 Period

Although the program was in existence, Lottery employees did not receive performance-based compensation payments for the January-June 2005 period. Lottery transfers during the period totaled about \$26.3 million, an amount that did not meet the levels specified in the incentive program. There were two major factors affecting the Lottery's revenues during the period: the cost of equipment for Casey's stores in Iowa and fluctuations in the Powerball jackpot.

In late 2005, Casey's General Stores began selling lottery products again in Iowa. A decade earlier, the Ankeny-based convenience store chain had made a corporate-wide decision to stop selling Lottery products in all states where it did business. That decision was based on a variety of reasons, including accounting issues. The Iowa Lottery is obviously pleased to be selling tickets again in Casey's locations in Iowa. However, the addition of the stores to the Lottery's retail base had some short-term costs that had to be weighed against significant long-term benefits to Lottery sales and proceeds.

The Lottery spent about \$1.6 million, with much of the cost falling in the January-June 2005 time period, to supply Iowa Casey's locations with requisite equipment including sales terminals, ticket dispensers, literature holders, and lottery signs. Those short-term costs had an immediate impact on the Iowa Lottery, but will more than be offset by the long-term benefit of having Casey's as a Lottery retailer.

Another factor in the Lottery's results during the January-June 2005 period were Powerball sales, which were down during the months involved. Changes made in the game since that time have had a significant, positive impact on sales.

Fiscal Year 2006 Information

Lottery sales and profits to the state both hit record levels in fiscal year 2006. Sales of the Lottery's two traditional product leaders (instant-scratch games and Powerball) both established records during the year as did overall sales for the Lottery.

Even without TouchPlay sales included, FY 2006 was a record sales year for the Lottery. Sales of all Lottery products except TouchPlay totaled \$218 million, which eclipsed the previous record of \$210.7 million set in FY 2005. When TouchPlay net sales are included in the Lottery figures for the year, Lottery sales in Iowa totaled \$339.5 million in FY 2006. Lottery profits to state programs totaled a record \$80.6 million for the fiscal year.

Powerball sales were a major force behind the Lottery's strong performance in fiscal year 2006, reaching a total of \$71.1 million (compared to \$54.2 million in FY 2005). Instant-scratch ticket sales totaled \$106.6 million (compared to \$103.3 million a year earlier). TouchPlay sales also were up for the year, totaling \$123.8 million (compared to \$6.4 million in FY 2005).

This year, there has been much publicity with regard to bonuses paid to employees of CIETC. Our understanding is that those funds were approved in large amounts mostly for upper management with no ties to accomplishment. The approval allegedly was done surreptitiously, with no report to the Legislature and involved commitments of tax dollars apparently intended for other purposes.

We realize there is political clamor with regard to special state employee compensation. We also realize that the Lottery's job is to maximize net revenue to the state through the trademarking and sale of products that it develops and promotes, and through responsible management of the funds under its jurisdiction. We believe that state entities should abide by their word – especially state lotteries. If a lottery breaks its word, the public might not have confidence that its prizes will be paid upon winning.

However, there was controversy with regard to the TouchPlay program which netted the state about \$27.3 million for FY 2006.

Lottery Board Decision Today

In view of the TouchPlay controversy, the Lottery Board voted today that TouchPlay figures not be figured into the Lottery's goals for FY 2006. Simply put, TouchPlay sales, profits and direct expenses will be left out entirely in the computation of the Lottery's performance-based compensation goals for the year.

The sales and profit assumptions that the Board used in 2004 to establish the performance-based compensation program for FY 2006 included \$12 million in TouchPlay sales and a resulting \$2.9 million in TouchPlay profits to the state.

With both those figures removed from the computation of the program goals, a 3 percent incentive would be paid to lottery employees if transfers to the state met or exceeded \$51.1 million in FY 2006. A payment of an additional 4 percent incentive would be paid if total

transfers met or exceeded \$54.6 million, and a prorated payment would be made for transfers that totaled somewhere in between.

Lottery results for FY 2006 with TouchPlay sales and profits removed show that Lottery sales totaled \$218 million while Lottery profits to state programs totaled \$54 million. That profit level falls between the minimum goal established by the Board of \$51.1 million in Lottery profits to the state for FY 2006 and the \$54.6 million profits level that would have meant an additional 4 percent payment.

Therefore, the Lottery Board voted that a prorated performance-based payment of 5.93 percent of Lottery staff's annual pay be made to each Lottery employee except the CEO, to whom the program does not apply. About 80 percent of the lottery employees who will receive a performance-based compensation payment are AFSCME-covered workers.

The State Auditor and Attorney General were both consulted about the performance-based compensation program and the Board's decision today. Both advised the Board that it was obligated to pay employees the performance-based compensation that had been established in 2004.

Lottery Board Membership

The members of the Iowa Lottery Board are:

- Timothy Clausen, a Sioux City attorney who is the Board's Chairperson.
- Michael McCoy of West Des Moines, an insurance executive who is the Board's Vice Chairperson.
- Mary Junge of Cedar Rapids, a CPA and practicing tax and estate-planning attorney.
- Elaine Baxter of Burlington, a former State Representative and Secretary of State.
- Michael Klappholz of Cedar Rapids, Chief of Police in Cedar Rapids.
- State Treasurer Michael Fitzgerald serves as an ex-officio member of the Board.